No. 644

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CEMENT INVESTORS, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 13–22) is unpublished. The opinion of the Circuit Court of Appeals (R. 194–200) is reported in 122 F. (2d) 380.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 24, 1941. (R. 200–201.) The petition for a writ of certiorari was filed on September 23, 1941. Following denial on February 9, 1942, a petition for rehearing was filed on February 28,

1942, and the petition was granted on March 9, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to a Section 77B plan, corporate assets were transferred to a new company, new bonds and stock distributed to former bondholders, and the stock interests eliminated except for the receipt of stock purchase warrants. The question is whether gain should be recognized upon the taxpayer's exchange of bonds for new bonds and stock. The answer depends upon (1) whether the exchange was tax-free under Section 112 (b) (3) of the Revenue Act of 1936, which in turn depends upon whether the plan constituted a "reorganization" within the definition of Section 112 (g) (1); or (2) whether the exchange constituted a tax-free transfer under Section 112 (b) (5).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 30–38.

STATEMENT

Prior to September 2, 1936, the taxpayer owned $44,000 face amount of Colorado Industrial Company first mortgage 5% bonds due August 1, 1934 (R. 14), which had an adjusted basis of $14,893.25 (R. 18). On September 2, 1936, the bonds were

exchanged in a proceeding under Section 77B of the Bankruptcy Act for $17,600 principal amount of income mortgage bonds and 880 shares of stock of a new company, The Colorado Fuel and Iron Corporation. (R. 18.)

The fair market value of the new securities received in the exchange was $37,884 (R. 36–37), exceeding the basis of the old by $22,990.75. The Commissioner determined deficiencies in income, excess profits and surtax on the ground that the profit from this exchange was a taxable gain. (R. 9, 13.)

The facts concerning the Section 77B proceeding are as follows:

The Colorado Industrial Company (hereinafter referred to as Industrial) was a wholly owned subsidiary of The Colorado Fuel and Iron Company (hereinafter referred to as Fuel & Iron). (R. 14.) The companies in 1934 had outstanding in the hands of the public the following classes of securities (R. 14):

Fuel & Iron	$4,500,000 general mortgage 5% bonds; 20,000 shares 8% $100 par value cumulative preferred stock; 340,507 shares no par common stock.
Industrial	$27,633,000 first mortgage 5% bonds.

Industrial's bonds were unconditionally guaranteed by Fuel & Iron both as to principal and interest. Industrial itself was not engaged in active business and had no assets of substantial value; virtually all of its properties had been transferred to Fuel & Iron in 1913. (R. 14.)

Interest payments due August 1, 1933, on both bond issues were defaulted and receivers were appointed the same day for the properties of Fuel & Iron by the United States District Courts in Colorado and Wyoming. On August 1, 1934, the companies defaulted in the payment of the principal of Industrial's bonds, and each filed a petition under Section 77B of the Bankruptcy Act in the United States District Court for the District of Colorado. (R. 14–15.)

A plan of reorganization, dated March 1, 1935, was formulated, and after approval by committees for the bondholders and stockholders was proposed by the debtors pursuant to Section 77B (d) of the Bankruptcy Act. (R. 15.) The plan provided for the formation of a new company, The Colorado Fuel and Iron Corporation, to which all the assets of the debtor companies would be transferred, subject to the lien of Fuel & Iron's general mortgage bonds. (R. 15, 16, 73.) The new company (hereinafter referred to as Fuel & Iron Corporation) would assume the obligations on the general mortgage bonds, and would issue $11,053,200 of income mortgage bonds and 552,660 shares of common stock which would be distributed in exchange for the Industrial bonds. (R. 16.) The stockholders of the debtor companies would receive no interest in the new company, but in exchange for their stock would be given warrants for the pur-

chase of an aggregate of 315,379 shares of the new stock at a specified price. (R. 16–17.)

Pursuant to direction of the court, the plan was submitted to the holders of the Industrial bonds and the Fuel & Iron preferred and common stock for acceptance by the requisite percentage under Section 77B. It was accepted by holders of 75.7% of the bonds, 61.3% of the preferred stock, and 53.2% of the common stock, and thereupon on April 25, 1936, was confirmed by the District Court and duly consummated. (R. 15.)

The following steps were among those taken in effecting the plan: (1) The assets of Fuel & Iron and Industrial were transferred by proper conveyance to the new company. (2) The new company issued its securities for distribution to the security holders pursuant to the provisions of the plan. (3) The reorganization managers notified the security holders that the new securities would be available for distribution on September 1, 1936. On or about that date the holders of Industrial bonds surrendered their bonds for cancellation in exchange for the bonds and stock of the new company, and the warrants were distributed to the new stockholders. (4) The first mortgage of Industrial which had secured its bonds was satisfied and discharged. (R. 16–17.)

Immediately after the consummation of the plan all of the issued stock of Fuel & Iron Corporation,

552,660 shares, belonged to former holders of the bonds of Industrial. (R. 17.) No stock was issued to other parties until October 23, 1936, when 37 shares were issued upon the exercise of warrants. Only 465 shares had thus been issued by June 30, 1938. (R. 17.)

The warrant agreement provided that the holders of warrants should not have the right to vote or to receive notice as stockholders, and should have no rights whatsoever as stockholders of the new company. (R. 16–17.) The option price under the warrants was considerably higher than the opening market price for shares of the new companies. (R. 17.)

The Board of Tax Appeals, rejecting the Commissioner's position, held that the transaction constituted a "reorganization" within the definition of Clause C of Section 112 (g) (1) of the Revenue Act of 1936, and that, therefore, gain or loss would not be recognized under Section 112 (b) (3). (R. 22.) The court below affirmed the decision of the Board both on this ground and on the further ground that gain or loss would not be recognized under Section 112 (b) (5). (R. 194–200.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the taxpayer's securities had been exchanged pursuant to a plan of "reorganization," and that therefore gain would not be recognized.

(2) In holding that Section 112 (b) (5) precluded recognition of gain upon the exchange of the taxpayer's securities.

(3) In failing to hold that the gain realized upon the exchange of the taxpayer's securities should be recognized under Section 112 (a).

(4) In sustaining the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

This case corresponds in all essential particulars to *Helvering* v. *Southwest Consolidated Corp.*, No. 286, decided February 2, 1942. That decision makes it clear that this transaction did not constitute a reorganization within the definition of the revenue laws. Accordingly, the exchange of securities was not made in pursuance of a plan of reorganization within the meaning of Section 112 (b) (3), and under the reorganization provisions of the statute, gain or loss should be recognized.

The issue thereupon presented is whether resort nevertheless may be had to the provisions of Section 112 (b) (5) in order to avoid recognition. This section, however, is applicable only where the subject of the transaction is disposed of by the transferor as property and is received by the transferee corporation as property in consideration for the securities issued in return. The "property" must pass as an asset from one to the other.

As the facts of this case illustrate, the property dealt with in a Section 77B plan, and which is

transferred to the new company, is the physical assets of the debtor, not its securities. The exchange of securities is a separate phase of the transaction in which the new company itself plays no direct part. It is not a second transfer of property to the new company somehow superimposed upon the one which actually takes place.

In making the exchange, the individual security holders do not transfer any property, either to the new company or to anyone else. Rather, upon surrender of the bonds for cancellation, the property interest in the securities is terminated. Conversely, the old bonds are never received as property by the new company.

Consideration of the statute as a whole, moreover, shows that the reorganization provisions of the statute were intended to be all-inclusive in dealing with the tax consequences of intercorporate transactions of this character. Injection of Section 112 (b) (5) into the situation, in order to provide a special exception for an exchange of securities which did not qualify under Section 112 (b) (3), is inconsistent with the framework upon which the statute is constructed. It destroys the synchronization which the reorganization provisions establish in these situations between the non-recognition provisions of Section 112 and the basis provisions of Section 113. It cannot be supposed that Congress intended such a fundamental incongruity.

Similarly, analysis of the facts, together with the Court's decision in *Helvering* v. *Southwest Con-*

solidated Corp., supra, makes it clear that the transaction cannot be construed as a transfer of the assets of the debtor companies *by the bondholders* within the meaning of Section 112 (b) (5).

ARGUMENT

Introductory.—Insolvency reorganizations, like that involved here, normally present several immediate tax problems. One is the basis of the corporate assets in the hands of the new company, and the governing principles with respect thereto under the 1934 Act and subsequent statutes have been authoritatively established in *Helvering* v. *Southwest Consolidated Corp.,* No. 286, decided February 2, 1942. A cognate question is whether the individual security holders recognize taxable gain or deductible loss upon the exchange of their securities. That is the question presented by the instant case.

The Government's position is that the statute requires correlative disposition of both questions. If there is a reorganization within the statutory definition and the old basis of the assets carries over under section 113 (a) (7) of the Act, gain or loss will not be recognized upon the exchange of securities under section 112 (b) (3). The application of both these sections depends upon whether there was a reorganization under Section 112 (g) (1). But if, as here, there is not a reorganization under the authority of the *Southwest Consolidated*

case, and therefore the old basis does not carry over, gain or loss should be recognized. We submit that there is no warrant for the inconsistent treatment of the two issues which would result if the decision below were affirmed.

I

THE TAXPAYER DID NOT EXCHANGE ITS SECURITIES IN PURSUANCE OF A PLAN OF REORGANIZATION WITHIN THE MEANING OF SECTION 112 (g) (1).

The opinion in *Helvering* v. *Southwest Consolidated Corp.* establishes the error of the court below in concluding that this transaction was a Clause C reorganization.

The two cases involve identical definitions of the term "reorganization",[1] and their facts correspond in all essential particulars. Each involved a readjustment, effected through judicial proceedings, in which the assets of the old corporation were transferred to a new corporation, and all the securities of the new company, except for stock purchase warrants, were distributed to the old creditors. In each case, the former stockholders received only the warrants; their interests were otherwise eliminated. In holding that the transaction in the *Southwest Consolidated* case did not qualify as a "reorganization" under Clause C of Section 112 (g) (1), the Court said:

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[1] Sections 112 (g) (1) of the Revenue Acts of 1934 and 1936.

That clause requires that "immediately after the transfer" the "transferor or its stockholders or both" be in "control" of the transferee corporation. "Control" is defined in § 112 (h) as "the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." Here "control" at the critical date was not in the old corporation or its "stockholders". The participating creditors had received pursuant to the plan rights to receive over a majority of the stock of the new company even though all of the warrants allocated to stockholders had been issued and exercised. The contrary conclusion was reached in *Commissioner* v. *Cement Investors, Inc.*, 122 F. 2d 380, 384, on the theory that the bondholders of the insolvent predecessor company could be regarded as its "stockholders" within the meaning of § 112 (g) (1) (C), since they had acquired an equitable interest in the property and were empowered to supplant the stockholders. We have adopted that theory in *Helvering* v. *Alabama Asphaltic Limestone Co., supra,* in determining whether the bondholders had retained a sufficient continuity in interest so as to bring the transaction within the statutory definition of merger or consolidation contained in the revenue acts prior to 1934. But it is one thing to say that the bondholders "stepped into the shoes of the old stockholders" so as to ac-

quire the proprietary interest in the insolvent company. It is quite another to say that they were the "stockholders" of the old company within the purview of clause C. In the latter Congress was describing an existing, specified class of security holders of the transferor corporation. That class, as we have seen, received a participation in the plan of reorganization. For purposes of clause C they must be counted in determining where "control" over the new company lay. They cannot be treated under clause C as something other than "stockholders" of the old company merely because they acquired a minority interest in the new one. Indeed clause C contemplates that the old corporation or its stockholders, rather than its creditors, shall be in the dominant position of "control" immediately after the transfer and not excluded or relegated to a minority position. Plainly the normal pattern of insolvency reorganization does not fit its requirements.

We submit that the *Southwest Consolidated* decision is determinative of the question here, particularly in view of the Court's express reference to this case. To be sure, the readjustment in the *Southwest Consolidated* case was effected in a receivership proceeding whereas this case involves a proceeding under Section 77B of the Bankruptcy Act. But this difference in the "procedural devices" employed to carry out the plan cannot be material. *Cf. Helvering* v. *Alabama Asphaltic*

Limestone Co., No. 328, decided February 2, 1942. In both cases, the decisive fact is that neither the old corporation nor its "stockholders" were in control of the new.

The court below based its decision solely on Clause C. This was the only clause which the taxpayer argued was applicable.[2] It may be noted, however, that the *Southwest Consolidated* decision also disposes of any possibility that Clause B, D, or E might apply. In that case, Clause B was held inapplicable because the new company did not acquire the assets *solely* for voting stock as that clause requires; in addition, warrants had been issued and cash paid. Here the new company issued bonds and warrants, as well as common stock, in return for the assets. Clauses D and E are likewise inapplicable since, as this Court stated—

> There was not that reshuffling of a capital structure within the framework of an existing corporation contemplated by the term "recapitalization." And a transaction which shifts the ownership of the proprietary interest in a corporation is hardly "a mere change in identity, form, or place of organization" within the meaning of clause E.

Since, therefore, the taxpayer did not exchange its securities in pursuance of a plan of "reorganization,"[2] the non-recognition provisions of Sec-

[2] The taxpayers in the two companion cases (*Helvering* v. *James Q. Newton Trust* and *Helvering* v. *James Q. Newton*,

tion 112 (b) (3) are inapplicable. The real issue before the Court is whether recognition of gain or loss upon the exchange may nevertheless be avoided under Section 112 (b) (5).

II

THE TAXPAYER'S EXCHANGE OF SECURITIES WAS NOT A TRANSFER OF PROPERTY WITHIN THE MEANING OF SECTION 112 (b) (5)

1. The inapplicability of Section 112 (b) (5) to a surrender of the securities of the old corporation in exchange for those of the new in a receivership or a Section 77B proceeding is shown at the outset by the plain language of the statute. Section 112 (b) (5) applies where "property" has been "transferred" to a controlled corporation. Like the other provisions of Section 112 (b) through (g), it creates a special exception to the general rule of Section 112 (a) requiring the recognition of all gains or losses upon sales or exchanges, and consequently it must be strictly construed; its meaning cannot be extended beyond the precise terms of the language employed. Treasury Regulations 94, Art.

Jr., Nos. 645 and 646, respectively) have argued that Clause A is applicable to render the transaction a "reorganization" within Section 112 (g) (1). This contention was rejected by the Board of Tax Appeals in *Newton* v. *Commissioner*, 42 B. T. A. 473, and it was not passed upon by the court below. We discuss it in our brief filed here in those two cases. The taxpayer in the instant case stated in its brief below (p. 26) its agreement with our view that Clause A does not apply.

112 (a)–1; Paul, Studies in Federal Taxation (3d Series) 53–54. To regard the exchange involved here as a "transfer" of "property" within this section would give those words a context far different from their normal meaning.

It should be plain that "property is transferred," within the meaning of Section 112 (b) (5), only where the "property" is both *disposed of* by the transferor as *property* and is *received* by the transferee corporation as *property* in consideration for the securities issued in return. The subject of the transaction must pass as property from one to the other. It must survive the transaction as an asset in the hands of the transferee.

That Section 112 (b) (5) thus assumes the continuance of the property in the hands of the transferee is confirmed by the correlative provision of Section 113 (a) (8), which prescribes the basis for "property * * * acquired * * * by a corporation * * * by the issuance of its stock or securities in connection with a transaction described in Section 112 (b) (5)".[3] The construction is also borne out by Article 112 (b) (5)–2 of the Regulations, which *inter alia*, provides that

[3] *Cf.* also Section 113 (a) (6), which after providing generally for the basis of property acquired upon an exchange described in Section 112 (b) to (e), inclusive, states: "This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

every person who receives "stock or securities of a controlled corporation for property under Section 112 (b) (5) shall file with his income tax return * * * a complete statement * * * including * * * a description of the property transferred, or of his interest in such property", and that "such controlled corporation" shall file with its return a "full description of all property received from the transferors." Treasury Regulations 94, Art. 112 (b) (5)-2, Appendix, *infra*.

It should also be clear that the exchange of securities in a Section 77B or receivership proceeding is not a transfer of property by the old security holders to the new company. The property dealt with in the plan, and which is transferred to the new company, is the physical assets of the debtor, not its securities. As the Court recognized in the *Southwest Consolidated* case, these assets are acquired from the debtor (not from the security holders), and it is in exchange for this property that the new company issues its securities.

Completion of the plan, of course, also involves an exchange of securities by the individual security holders. But in making the exchange, the security holders do not transfer property to the new company. They merely surrender their old claims for cancellation (either to the debtor, or to the trustee or reorganization managers acting in its behalf) and take the new securities, which

have been issued by the new company in exchange. The obligations of the debtor companies are thereupon discharged. The property interest in the old securities is terminated, and never passes from the security holders either to the new company or to anyone else. The physical instruments retain at most an historical value.[4]

Conversely, the old bonds are never received as property by the new company. The exchange, indeed, is a separate phase of the transaction in which the new company itself plays no part. Ordinarily, as here, it will not even take possession of the physical instruments in the mechanics of effecting the exchange. At no point in the proceeding does the new company become the owner of the bonds of the old, with all the rights of a creditor of the old, as it necessarily would if the bonds had been "transferred" to it.

2. This distinction between the transfer of the assets of the debtor to the new company and the exchange of the securities is recognized by the provisions of Section 77B itself. Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended by Act of June 7, 1934, c. 424, 48 Stat. 911, Sec. 1 (U. S. C., Title 11, Sec. 207). Subsection (b) (9) provides that the plan "shall provide adequate means for the execution of the plan, which may include the transfer of all or any part of the prop-

[4] See 19 Fletcher, Cyclopedia of Corporation Law (Permanent Ed.), § 9395. Ordinarily the old instruments will be destroyed. *Ibid.*

erty of the debtor to another corporation * * * and the issuance of securities of either the debtor or any such corporation or corporations, for cash, or in exchange for existing securities, or in satisfaction of claims or rights, or for other appropriate purposes," and Subsection (b) (10) provides that the plan "may deal with all or any part of the property of the debtor". Under Subsection (h), the "property dealt with by the plan", when transferred to the other corporation, "by the trustee or trustees", or by the debtor, if it has been retained in possession, shall be free and clear of all claims of the debtor, its stockholders and creditors, except those which may consistently with the plan be reserved. The final decree, on the other hand, "shall discharge the debtor from its debts and liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved as aforesaid." See *In re Corona Radio & Television Corp.*, 102 F. (2d) 959, 962 (C. C. A. 7th); *In re James Butler Grocery Co.*, 100 F. (2d) 376, 378 (C. C. A. 2d).

The plan in the instant case was carried out in accordance with these provisions. The plan provided for the creation of a new company to "acquire directly or otherwise all of the assets" of Fuel & Iron and Industrial (R. 73–74) and stated, as one of its objectives, that the "$27,633,000 of funded debt, represented by the Industrial Bonds, is to be replaced in part by $11,053,200 of new 5% Income

Mortgage Bonds due in 1970 and in part by common stock." (R. 69.)

Following confirmation, the court, on June 20, 1936, entered an "Order Approving the Form of Documents and Directing the Transfer of Assets to, and the Issue of Securities and Assumption of Liabilities by, the New Company." (R. 131–142.) In this order the debtor companies, the reorganization trustee and the indenture trustee were directed to transfer all their interests in the assets to the new company, in exchange for the new securities to be issued to or on the order of the reorganization managers. (R. 133–134.) The indenture trustee was directed to execute a proper instrument satisfying and discharging the Industrial mortgage. (R. 135–136.)

Article Four of the order set forth the manner and terms of distribution of the new securities. (R. 138–140.) It was provided that the reorganization managers, as soon as reasonably practical after the issuance of the new securities, should distribute them to the old stockholders, subject to "reasonable regulations and instructions governing the endorsement and surrender of securities of the Debtors." (R. 138.) The new securities would be distributed "Upon surrender to the Reorganization Managers, or to the Distributing Agents, of outstanding Industrial Bonds or certificates of Preferred and Common Stock of the Fuel and Iron Company * * *". (R. 139.)

This order was duly carried out. An indenture and bill of sale was executed which transferred the

assets of the debtors to the new company in consideration of the issuance of the new securities. (R. 170–179.) The security holders were duly notified by the reorganization managers that the new securities were ready for distribution. (R. 168–170.) They were advised that in order to obtain the securities they "must surrender their bonds or stock certificates" to the distributing agents. (R. 168.) As found by the Board, their bonds were thereupon surrendered for "cancellation." (R. 17.)

Thereafter, on October 12, 1938, the court entered its final decree providing (R. 190–191)—

> That all debts and liabilities of The Colorado Fuel and Iron Company and of The Colorado Industrial Company, Debtors, and all rights and interests of the stockholders of said Debtors, and each of them, be and the same are discharged, * * *. All creditors and stockholders of said Debtors and each of them are hereby enjoined from enforcing or attempting to enforce in any manner or form whatsoever any rights, claims or demands against said Debtors, or against The Colorado Fuel and Iron Corporation, or the officers, agents, or stockholders thereof, or against the assets of The Colorado Fuel and Iron Corporation, save and except in the manner and to the extent provided for in said Plan of Reorganization and the orders of Court above mentioned.

Every aspect of the plan, as thus carried out, negatives the notion that the exchange of the secu-

rities constituted a transfer of property to the new company. Although the transaction must be considered as a whole (*Helvering* v. *Southwest Consolidated Corp., supra*), it necessarily involved two phases: first, the transfer of the corporate assets to the new company, and secondly, the exchange of securities. The very nature of the transaction leaves no room for the argument that property was transferred to the new company by this exchange. The property dealt with in the plan had already been transferred and the new securities issued by the new corporation. These new securities were then distributed in order to replace the interests represented by the old cancelled obligations. It is impossible, even in a metaphysical sense, to conceive of this phase of the transaction as constituting a second transfer of property somehow superimposed upon the first.

3. The question whether a bond is transferred as property, when it is surrendered for cancellation and the claim discharged, is akin to that presented in *Fairbanks* v. *United States*, 306 U. S. 436. In that case, the Court held that upon redemption of a corporate bond, the bondholder, surrendering his security, did not sell or exchange a capital asset within the meaning of Section 208 (a) (1) of the Revenue Act of 1926, and Section 101 (c) (1) of the Revenue Act of 1928.[5] Cf. *Helvering* v. *Flaccus*

[5] Revenue Act of 1926, c. 27, 44 Stat. 9:

"SEC. 208. (a) For the purposes of this title—

Leather Co., 313 U. S. 247. A contrary result would have been called for, if it could be said in the present situation that the surrender of a claim, upon receipt of new securities in satisfaction of the obligation, constitutes a transfer of property.

Even more closely in point are those decisions holding that where a secured claim is surrendered and cancelled, upon acquisition of the security, the creditor has not sold or exchanged a capital asset. *Bingham* v. *Commissioner*, 105 F. (2d) 971 (C. C. A. 2d); *Commissioner* v. *National Bank of Commerce*, 112 F. (2d) 946 (C. C. A. 5th); *Commissioner* v. *Spreckels*, 120 F. (2d) 517 (C. C. A. 9th); see *Commissioner* v. *Electro-Chemical E. Co.*, 110 F. (2d) 614, 616 (C. C. A. 2d), affirmed, 311 U. S. 513; *cf. Hale* v. *Helvering*, 85 F. (2d) 819 (App. D. C.). These cases turned on the ground that the surrender was not a transfer of the property to the debtor. As stated in *Bingham* v. *Commissioner* (105 F. (2d) at 972):

> What may have been property in the hands of the holder of the notes simply vanished when the surrender took place and the maker received them. He then had, at most, only his own obligations to pay himself. Any theoretical concept of a sale of the

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"(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921; * * *" Except for formal differences, Section 101 (c) (1) of the Revenue Act of 1928, c. 852, 45 Stat. 791, is the same.

notes to the maker in return for what he gave up to get them back must yield before the hard fact that he received nothing which was property in his hands but had merely succeeded in extinguishing his liabilities by the amounts which were due on the notes. There was, therefore, no sale of the notes to him in the ordinary meaning of the word and no exchange of assets for assets since the notes could not, as assets, survive the transaction. That being so, such a settlement as the one this petitioner made involved neither a sale nor an exchange of capital assets within the meaning of the statute. *Hale* v. *Helvering, supra; United States* v. *Fairbanks,* 9 Cir., 95 F. 2d 794; *Fairbanks* v. *United States,* 59 S. Ct. 607, 608, 83 L. Ed. 855; *Felin* v. *Kyle,* 3 Cir. 102 F. 2d 349.

Conversely, the situation here is readily distinguishable from one in which intangibles are transferred *as property* to a controlled corporation. *Portland Oil Co.* v. *Commissioner,* 109 F. (2d) 479 (C. C. A. 1st), certiorari denied, 310 U. S. 650; *P. A. Birren & Son* v. *Commissioner,* 116 F. (2d) 718 (C. C. A. 7th). Thus, a transfer of securities by an individual to a personal holding company in exchange for its stock would fall within Section 112 (b) (5), but in that situation the transferred securities would represent "property" in the hands of the transferee corporation.

4. Consideration of the revenue statute as a whole, moreover, shows that Section 112 (b) (5)

was not intended to provide nonrecognition of gain or loss upon an exchange of securities in an intercorporate transaction which is not a "reorganization" under Section 112 (g).

The reorganization provisions of the statute cover every taxable phase of a typical intercorporate transaction: the exchange of securities (Section 112 (b) (3)); the transfer of the corporate assets (Section 112 (b) (4)); the basis of the new securities (Section 113 (a) (6)); and the basis of the property received by the transferee (Section 113 (a)(7)). They are patterned on the theory that in these situations there should be a definite correlation between the disposition of the two questions of nonrecognition of gain or loss and the carryover of basis. Thus, in each instance, the application of the provisions depends upon the existence of a "reorganization" within the definition of Section 112 (g) (1). If there is a reorganization, gain or loss will not be recognized either upon the corporate transfer (Section 112 (b) (4)) or upon the exchange of securities (Section 112 (b) (3)); the basis of the new securities received in the exchange will be the same as that of the old (Section 113 (a) (6)); and the basis of the assets in the new company will be the same as in the hands of the old (Section 113 (a) (7)). Conversely, if there is not a reorganization, gain or loss will be recognized and new cost bases will be taken.*

* Development of this theory of uniformity is illustrated by amendments adopted to Section 113 (a) (7). When the

Since the reorganization provisions thus present a comprehensive scheme for dealing with intercorporate transfers, and since those provisions do not confer the exemption sought by the taxpayer herein, it is not to be supposed that Congress intended to alter the operation of those provisions by resort to Section 112 (b) (5). Section 112 (b) (5) was intended to have an independent sphere of operation where an individual transferred property to a controlled corporation. Of course, there may be overlapping between Section 112 (b) (5) and Section 112 (g) (1) (C), where a *corporation* transfers property to a controlled corporation. But in that situation the tax consequences, both as to non-recognition and basis, are the same whether Section 112 (b) (5) or the reorganization provisions are employed, and the correlation between

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counterpart of this provision was first enacted in 1924 it contained the requirement that not only must the assets have been acquired in connection with a reorganization but also that "immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them." Revenue Act of 1924, c. 234, 43 Stat. 253, Section 204 (a) (7). In 1932, the requirement was reduced to 50%. Revenue Act of 1932, c. 209, 47 Stat. 169, Section 113 (a) (7). Finally, the requirement was eliminated entirely with respect to transactions occurring after December 31, 1935. Section 113 (a) (7), Revenue Act of 1936, c. 690, 49 Stat. 1648, as amended by Section 807 of the Revenue Act of 1938, c. 289, 52 Stat. 447. See H. Rep. No. 1860, 75th Cong., 3d Sess., p. 32 (1939–1 Cum. Bull. (Part 2) 728, 751). Consequently, synchronization is now complete.

the non-recognition and the basis provisions is preserved. See Section 113 (a) (8) and 113 (a) (6), Appendix, *infra*, pp. 33, 32.

In this case, however, the application of Section 112 (b) (5) would run counter to the reorganization provisions, and would destroy the synchronization which Congress established between the non-recognition provisions of Section 112 and the basis provisions of Section 113. Since there is no reorganization here, the basis of the assets in the hands of the new company is not their basis in the hands of the old corporation under Section 113 (a) (7), but their cost upon acquisition. *Helvering* v. *Southwest Consolidated Corp., supra.* Consistently with this result, the reorganization provisions contemplate that gain or loss should be recognized upon the exchange of the securities. This correlation was plainly intended and generally had been assumed to exist.[1]

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[1] In the consideration of the *Southwest Consolidated* case and companion cases (*Bondholders Committee et al.* v. *Commissioner*, Nos. 128–129, *Helvering* v. *Alabama Asphaltic Limestone Co.*, No. 328, and *Palm Springs Holding Corp.* v. *Commissioner*, No. 503, all decided by this Court February 2, 1942), the taxpayers involved protested that our position on the basis issue was inconsistent with the Commissioner's prior denial of losses upon the exchange of securities. We pointed out that while in the past it had been necessary administratively to take the position in each case that was necessary to protect the revenues, we recognized that if a new cost basis was adopted for the new com-

Resort to Section 112 (b) (5) to reach a contrary result produces an obvious and fundamental incongruity. If the securities received in the exchange do not provide a sufficient continuity of interest under the statute to warrant a carry-over of the old basis, it must follow that there is not a sufficient identity of interest between the old and the new securities to warrant non-recognition of gain or loss to the individual holders. We can perceive no justification for attributing to Congress an intention to adopt inconsistent theories in the disposition of the two questions.

III

THE TRANSACTION DID NOT CONSTITUTE A TRANSFER OF THE ASSETS OF THE DEBTOR CORPORATIONS BY THE BONDHOLDERS IN RETURN FOR THE NEW SECURITIES WITHIN THE MEANING OF SECTION 112 (b) (5)

The opinion of the court below is susceptible of the interpretation that the taxpayer was entitled

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pany a corollary gain or loss should be recognized upon the exchange of the securities. (*Southwest Consolidated* case, Br. 10, 13–14.)

It should be observed that the Government's position in the instant case cuts both ways. If sustained the Government would tax a gain in this case, but by the same token would recognize losses incurred by security holders, to the extent permitted by the revenue acts. (See *Southwest Consolidated* case, Br. 14, fn. 8). It may be assumed that the reorganization of an insolvent corporation would give rise more frequently to individual losses than gains.

to the benefit of Section 112 (b) (5) on the theory that the transaction constituted a transfer of the *corporate assets* by the *bondholders* in exchange for the new securities. There are two ready answers.

In the first place, the theory is premised upon a distortion of the facts. The transfer of the assets was made, as we have shown, by the reorganization trustee, the debtor corporations, and the indenture trustee, acting pursuant to court order. The bondholders had nothing to do with it.

In the second place, the result would be directly inconsistent with *Helvering* v. *Southwest Consolidated Corp., supra.* If Section 112 (b) (5) applied in this manner, then, by virtue of Section 113 (a) (8), the new company in that case would have been entitled to the basis of the assets in the hands of the bondholders as transferors. The Court held, however, that the basis would be cost. Moreover, in view of the parallel between Clause C and Section 112 (b) (5), a decision that Section 112 (b) (5) applied, although Clause C of Section 112 (g) (1) did not, would require a frivolous distinction; namely, that while the bondholders were not stockholders under Clause C, they are transferors under Section 112 (b) (5). If this distinction were drawn, the decision in the *Southwest consolidated* case would be pointless and meaningless.

CONCLUSION

The judgment of the court below should be reversed.

Respectfully submitted.

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APRIL, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*— * * *

* * * * *

(3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) SAME—GAIN OF CORPORATION.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of

the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * * *

(g) *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however, effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

* * * * * *

(h) *Definition of Control.*—As used in this section the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * * *

SEC. 113 [as amended by Section 807 of the Revenue Act of 1938, c. 289, 52 Stat. 447]. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*— The basis of property shall be the cost of such property; except that—

* * * * * *

(6) TAX-FREE EXCHANGES GENERALLY.— If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis (except as provided in paragraph (15) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(7) TRANSFERS TO CORPORATION.—If the property was acquired—

(A) after December 31, 1917, and in a taxable year beginning before January 1,

1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

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Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as added by Act of June 7, 1934, c. 424, 48 Stat. 911:

SEC. 77B. CORPORATE REORGANIZATIONS.—* * *

(b) A plan of reorganization within the meaning of this section (1) shall include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character or otherwise; * * * (9) shall provide adequate means for the execution of the plan, which may include the transfer of all or any part of the property of the debtor to another corporation or to other corporations, or the consolidation of the properties of the debtor with those of another corporation, or the merger or consolidation of the debtor into or with another corporation or corporations, or the retention of the property by the debtor, the distribution of assets among creditors or any class thereof, the satisfaction or modification of liens, indentures, or other similar instruments, the curing or waiver of defaults, extension of maturity dates of outstanding securities, the change in interest rates and other terms of such securities, the amendment of the charter of the debtor, and the issuance of securities of either the debtor or any such corporation or corporations, for cash, or in exchange for existing securities, or in satisfaction of claims or rights, or for other appropriate purposes; (10) may deal with all or any part

of the property of the debtor and may include any other appropriate provisions not inconsistent with this section. * * *

* * * * * *

(h) Upon final confirmation of the plan, the debtor and other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and control of the judge, and the property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed, when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the court may direct the trustee or trustees, or if there be no trustee, the debtor and any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may direct the debtor to join in any such transfer or conveyance made by the trustee or trustees. Upon the termination of the proceedings a final decree shall be entered discharging the trustee or trustees, if any, making such provisions as may be equitable, by way of injunction or otherwise, and closing the case. Such final decree shall discharge the debtor from its debts and

liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved as aforesaid. * * * (U. S. C., Title 11, Sec. 207.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 112 (b) (5)–1. *Transfer of property to corporation controlled by transferor.*—As used in section 112 (b) (5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 1001); and to be in "control" of the transferee corporation such person or persons must own immediately after the transfer at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. (See section 112 (h).) The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Example 1: A owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $150,000 in 1936. He transfers this property to the M Corporation, a newly formed company, for all the latter's capital stock. No gain or loss is recognized from the transaction.

Example 2: C owns a patent right worth $25,000 and D owns a manufacturing plant, worth $75,000. C and D organize the R cor-

poration with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example 3: B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1936. He transfers the property to the N Corporation in 1936 for 78 percent of all classes of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112 (h).)

ART. 112 (b) (5)–2. *Records to be kept and information to be filed.*—Every person who receives the stock or securities of a controlled corporation for property under section 112 (b) (5) shall file with his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

1. A description of the property transferred, or of his interest in such property, together with a statement of the cost or other basis thereof, adjusted to the date of the transfer, and

2. A statement of the amount of stock or securities and other property or money received in the exchange. The amount of each kind of stock or securities and other property received shall be set forth at its fair market value at the date of the exchange.

Every such controlled corporation shall

file with its income tax return for the taxable year in which the exchange takes place:

(1) A full description of all property received from the transferors, together with a statement of the cost or other basis thereof in the hands of the transferors adjusted to the date of the transfer, and

(2) A statement of the amount of stock or securities and other property or money which passed to the transferors in the transaction, together with a full statement of the amount of the issued and outstanding stock and securities of such controlled corporation immediately after the exchange and of the ownership of each transferor of each class of stock of such controlled corporation immediately after the exchange (showing as to each class the number of shares and percentage owned and the voting power of each share).

Permanent records in substantial form shall be kept by every taxpayer who participates in a tax-free exchange under section 112 (b) (5) showing the cost or other basis in his hands of the transferred property, and of the amount of stock or securities and other property or money received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received in the exchange.

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